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Projecting Employment Insurance Premium Revenues and Expenses

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The *Parliament of Canada Act* mandates the Parliamentary Budget Officer (PBO) to provide independent analysis to the Senate and House of Commons on the state of the nation's finances, government estimates and trends in the national economy.

This note provides the methodology underlying the projection of Employment Insurance revenues and expenditures in PBO's *Assessment of the Budget 2010 Economic and Fiscal Outlook*.

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Key Points and Issues for Parliamentarians

Underlying PBO's projection of Employment Insurance (EI) premium revenues and benefit payments is a projection of EI premium rates produced using a methodology consistent with the annual reports of the EI Chief Actuary on EI premium rates, and the most recent legislation regarding the rate-setting mechanism.

PBO projects that EI premium rates for employees will increase by the maximum allowable amount of $0.15 per year to $2.33 (per $100 of insurable earnings) by 2014 from $1.73 in 2010. This $0.60 increase in the premium rate is projected to raise the annual contribution per worker by $535, on average ($223 borne by the employee and $312 borne by the employer).

Despite these premium rate increases, PBO projects that the Canada Employment Insurance Financing Board (CEIFB) reserve would remain in deficit through the end of 2014. The deficit peaks at $10.7 billion in 2011 before falling to $0.7 billion by 2014.

An extension of PBO's premium rate projection suggests that premium rates will likely vary significantly over the long term. The variability in premium rates is the result of the rate-setting mechanism and the Government's treatment of EI policy actions which raises important issues for parliamentarians to consider regarding the CEIFB, including:

- How do policy actions taken by the Government impact the finances of the CEIFB?
  - For example, the CEIFB will be explicitly compensated for the cost of the benefit enhancements announced in Budget 2009 but not for the cost of the premium rate freeze or the extension of benefits for long-tenured workers announced in Budget 2010.

- Should the legislation governing the rate-setting mechanism be reconsidered to facilitate adjustments in the time and manner in which advances by the Government need to be repaid by the CEIFB?
  - How quickly the CEIFB repays advances made to it by the Government will affect the reserve and changes to the premium rate (see Figure 1 on page 4).

- What size of reserve will enable the CEIFB to keep premium rates stable over time?
  - The size of the downturn experienced in 2009 and 2010, and PBO's projections of reserve deficits and premium rate changes that occur as a result suggest that a $2 billion reserve may be insufficient to ensure premium rate stability over time.

Introduction

PBO has developed a model that produces projections of Employment Insurance (EI) premium revenues and benefit payments – significant components of PBO's fiscal projection – on a Public Accounts basis. Underlying the Public Accounts projection is a projection of EI premium rates that is produced using a methodology consistent with the annual reports of the EI Chief Actuary (CA) on EI premium rates, and the most recent legislation regarding the rate-setting mechanism.

In its assessment of Budget 2010[1], PBO provided five-year projections for EI premium revenues and benefit payments. In the assessment, EI benefits are expected to fall from a recent peak of $22 billion to $19.7 billion over the projection horizon, owing to improving labour market conditions and the end of temporary measures initiated in Budget 2009. EI premium revenues, on the other hand, are projected to rise from $16.2 billion in 2009-10 to $27.1 billion in 2014-15, owing to increased employment and wage growth and projected increases in the EI premium rate.

The details of PBO's methodology and an overview of the main results will be discussed in what follows. Annex A provides the detail behind PBO's projection of economic variables. Annex B discusses PBO's premium rate projection and the CEIFB reserve. Annex C contains an overview of EI finances and the evolution of the EI premium rate-setting mechanism.

EI Benefits

PBO projects benefit payments in two parts consistent with the Public Accounts of Canada. Part I payments include income benefits (regular, fishing and work sharing) and special benefits (maternity, parental, sickness, adoption and compassionate care) as well as benefit repayments[2]. Part II payments include employment benefits (skills development, self-employment, job creation partnerships and targeted wage subsidies) and support measures (employment assistance, labour market partnerships, and research and innovation) as well as payments transferred to provinces and territories relating to Labour Market Development Programs[3].

Projecting regular EI payments requires projections of the number of unemployed, the proportion of unemployed individuals that will qualify for EI benefits (the beneficiaries-to-unemployment ratio (B/U) ratio) and average regular benefit payments. Average regular benefit payments (i.e. total regular payments divided by the number of regular beneficiaries) are assumed to grow in line with average weekly earnings[4]. The assumptions behind the PBO's projections of the number of unemployed, the B/U ratio and insurable earnings are discussed in Annex A.

Maternity, parental, sickness and adoption benefits are assumed to grow in line with insurable earnings while fishing, work sharing and sickness benefits are assumed to grow at the same rate as regular benefits. Benefit repayments are assumed to be a constant 1.75 per cent of regular and fishing benefit payments as per the 2009 CA Report.

Employment benefit and support measures (Part II of the EI Act) are held constant throughout the projection since the total value of these programs is legislated and therefore is not tied to the growth in wages. However, an additional $500 million has

[1] See: http://www2.parl.gc.ca/sites/pbo-dpb/documents/Budget_2010_Outlook.pdf

[2] Benefit repayments are negative because they are EI overpayments due to the Government and thus represent a reduction in costs.

[3] Administration costs also represent a cost to the EI program. However, since these costs are not benefit or support payments, they are included in direct program spending rather than transfers to persons. In 2008-09 administration costs were $1.8 billion, about 10 per cent of the total cost of the EI program.

[4] An additional $165 million and $600 million has been added in 2009-10 and 2010-11, respectively, following the announcement in Budget 2010 of the extension of regular benefits to long-tenured workers.

been added in 2009-10 and 2010-11 following the announcement in Budget 2009 for additional funding for Employment Insurance and Training Programs. PBO's EI benefit projection is the sum of all benefit payments, income benefits and support measures and benefit repayments (Table 1). These benefit payments form a part of transfers to persons in PBO's projection of federal expenditures.

Table 1

Employment Insurance Benefit Payments

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Beneficiaries							
B/U Ratio (regular benefits, per cent)	43.8	49.6	45.2	44.3	44.3	44.3	44.3
Regular EI Beneficiaries	529,828	769,808	705,356	636,592	604,648	568,307	550,551
Part I Benefit Payments							
Regular Benefits	10,102	15,257	14,911	13,280	12,977	12,542	12,519
Maternity, Parental, and Adoption Benefits	2,941	2,968	3,090	3,220	3,348	3,484	3,624
Fishing, Work Sharing, and Sickness Benefits	1,319	1,491	1,522	1,514	1,548	1,581	1,627
Benefit Repayments	-175	-274	-268	-238	-233	-225	-225
Total Part I Payments	14,186	19,442	19,255	17,775	17,640	17,382	17,546
Part II Benefit Payments							
Employment Benefits and Support Measures	2,112	2,612	2,612	2,112	2,112	2,112	2,112
Total Benefit Payments	**16,298**	**22,054**	**21,867**	**19,887**	**19,752**	**19,494**	**19,658**

Sources: Office of the Parliamentary Budget Officer; Statistics Canada, Public Accounts of Canada.

Notes: Benefit payments are in millions of dollars.

EI Premium Revenues

EI premium revenues are simply the sum of EI premiums paid by employees and firms for each individual employee. The amount of EI premiums paid by an individual employee is calculated by multiplying the legislated premium rate by the employee's insured earnings. Employers pay 1.4 times this amount. Insured earnings are those wages and salaries earned by an employee up to the annual maximum insurable earnings (MIE) amount, set annually by the EI commission[5]. As a result, there are two key drivers of EI premium revenues – insurable earnings and the premium rate.

To project insurable earnings, two types of employed individuals must be considered – employees with earnings greater or equal to MIE and employees with earnings less than MIE. The total earnings of each type of employee are a function of the number of employees in each group and the average earnings of the group. PBO's projection of total insurable earnings is the sum of earnings from each group (see Annex A for details).

Total insurable earnings are further divided between provinces that have their own provincial plans and provinces that do not[6]. The proportion

[5] MIE for a given year are set equal to MIE in the previous year multiplied by the growth in wages (year-over-year basis as of June 30th) from the Survey of Employment Payroll and Hours (SEPH) rounded to the nearest $100

[6] The 2010 CA report defines a Provincial Plan as "a plan, established under a provincial law, that provides for the payment of provincial benefits (PB) and in respect of which an agreement has been entered into between the Government of Canada and the province to establish a system for reducing employer and employee premiums where the payment of those benefits would have the effect of reducing or eliminating benefits payable under section 22 or 23 of the

of earnings from provinces without provincial plans is taken from the 2010 CA report and is held constant at its 2009 level throughout the projection period.

For premium rate projections, PBO is guided by the revised version of the EI Act, which states that the CEIFB[7] will set the premium rate such that EI contributions equal expenses plus any advances made to the CEIFB by the Government to cover past deficits in the CEIFB's reserve[8]. PBO refers to this rate as the break-even rate. The Act, however, also limits the change in the annual premium rate (referred to as the legislated rate) to a maximum of $0.15 (see Annex B for details).

To produce a projection for EI revenues on a Public Accounts basis, PBO utilizes an effective premium rate[9] that is then multiplied by projected insurable earnings to generate the employee portion of total premium revenues[10]. Total EI premium revenues are the employee portion plus the employer portion. Although they are included as revenues of the EI Account, contributions made by the federal government on behalf of its own employees, are subtracted from this total in the consolidated financial statements of the Government of Canada. This amount ($330 million in 2008-09) is assumed to grow in line with EI revenues throughout the projection.

Table 2 displays projected premium rates and resulting EI revenues as well as projections of the CEIFB reserve. Budget 2009 kept premium rates frozen for 2010 at $1.73 for every $100 of insurable earnings. For 2011 and beyond, PBO utilizes the break-even rate to determine premium rate movements. If the difference between the break-even rate and the legislated rate is less than $0.15, the break-even rate becomes the new legislated rate. If the difference between the rates is greater than $0.15 the premium rate is adjusted by $0.15 toward the break-even rate. As such, PBO projects the legislated premium rate to increase by the maximum allowable amount of $0.15 every year until 2014, culminating in a legislated rate of $2.33 in that year.

Table 2

Premium Rates, CEIFB Reserve and EI Revenues

	2008	2009	2010	2011	2012	2013	2014
Premium Rates							
Legislated Premium Rate	1.73	1.73	1.73	1.88	2.03	2.18	2.33
Break-even Rate	1.95	2.51	3.06	3.09	3.00	2.84	2.50
EI Reserve							
Annual Balance	0	-6,523	-6,543	-1,883	891	3,896	6,732
Benefit Enhancement			2,900				
Reserve Initialization				2,000			
Interest			-241	-447	-526	-539	-372
Cummulative Balance	0	-6,523	-10,407	-10,737	-10,371	-7,014	-655
	2008-09	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**
EI Revenues	**16,887**	**16,182**	**17,270**	**19,745**	**22,351**	**25,154**	**27,150**

Sources: Office of the Parliamentary Budget Officer.

Notes: Premium rates are expressed as dollars per $100 of Insurable earnings for provinces without provincial benefit plans. CEIFB reserves are expressed millions of dollars.

Despite the premium rate increases, PBO projects deficits in the CEIFB reserve throughout the projection period with the deficit peaking at $10.7 billion in 2011, before decreasing to $0.7 billion in 2014.

The reserve figures include a $2.9 billion payment from the Government to the CEIFB to compensate for benefit-enhancement measures announced in Budget 2009, interest on advances from the Government to the CEIFB, as well as a $2.0 billion transfer from the government in 2011 to initialize CEIFB's reserve.

Act." Quebec is currently the only province with a provincial plan.

[7] The CEIFB is a crown corporation that was established through legislation introduced in the 2008 Budget Implementation Act. This entity will be responsible for setting EI premium rates beginning in 2011.

[8] The fair market value of CEIFB's reserve is to be maintained at $2 billion plus indexation.

[9] The effective rate is one that adjusts the legislated premium rate to incorporate year-to-date information from the Fiscal Monitor and account for historical differences between contributions generated from legislated rates and insurable earnings and actual contributions in the Public Accounts.

[10] Employee contributions from provinces with provincial plans (Quebec) are actually calculated separately from provinces without provincial plans as per the CA methodology.

Implications of the Premium Rate-Setting Mechanism Over the Long Term

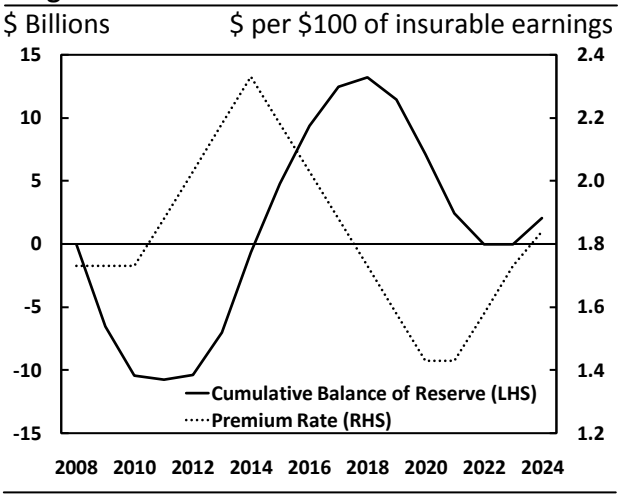
Figure 1 presents the results of PBO's projection for EI premium rates and the CEIFB reserve extended to 2024[11]. Large deficits in the CEIFB reserve over the 2009 to 2012 period are gradually eliminated by increasing the premium rate to $2.33 by 2014. However, by the time this deficit has been eliminated the premium rate is significantly greater than the rate needed to maintain the desired reserve ($2 billion) requiring six consecutive rate reductions of $0.15, resulting in a $1.43 premium rate in 2020. As before, this sequence of rate reductions leads to annual reserve deficits, which need to be offset with premium rate increases bringing the premium rate back to $1.84 by 2024. At this point the reserve would be at its desired level, allowing premium rates to remain relatively stable into the future.

PBO believes the premium rate instability presented in Figure 1 is function of the rate setting mechanism and the Government's treatment of EI stimulus measures announced in the 2009 and 2010 budgets. As part of the measures to help Canadian and stimulate spending in Budget 2009, the Government announced EI benefit enhancements totaling $2.9 billion as well as an EI premium rate freeze valued at $2.4 billion for the period 2009-10 to 2010-11[12]. Budget 2010 further enhanced EI benefits by extending regular benefits of long-tenured workers. The stimulus value of this enhancement is $165 million for 2009-10 and $600 million for 2010-2011.

Budget 2010 notes that once the premium rate freeze is lifted in 2011, premium rates will be set by the CEIFB and that, "the CEIFB will not be mandated to recover any EI deficits resulting from the $2.9 billion in the benefit enhancements announced in Budget 2009."[13] The fact that the CEIFB is required to recover the stimulus measures related to the benefit enhancements announced in Budget 2010 ($765 million) and the premium rate freeze ($2.4 billion) announced in Budget 2009 increases the deficits in the CEIFB reserve as well as the size of the premium rate increase required to eliminate them.

Figure 1

Premium Rates and the CEIFB Reserve over the Long Term



Source: Office of the Parliamentary Budget Officer.

Another key factor in premium rate stability is the time and manner in which CEIFB has to repay advances made to it by the Government to cover past reserve deficits. PBO has assumed that the CEIFB will increase premiums, subject to the $0.15 provision, in order to return the reserve to $2 billion as quickly as possible. However, the CEIFB could foresee the premium rate instability caused by this action and could choose to forego one or more premium rate increase and incur deficits for a longer period of time instead. Of course, the ability of the CEIFB to make this tradeoff is conditional on the terms and conditions of the advances made to it by the Government. Subsection 80(2) of the EI Act states that advances "shall be repaid in the time and manner and on the terms and conditions that the Minister of Finance may establish." Further detail regarding the repayment of advances could help clarify the constraints surrounding CEIFB's rate-setting decision.

[11] EI benefit and premium revenues projections are extensions of the methodology discussed earlier in the briefing note. Long-term projections of economic variables are consistent with PBO's Fiscal Sustainability Report.
[12] Budget 2009, page 121.
[13] Budget 2010, page 178.

The size of the reserve also plays a role in premium stability since a larger reserve provides a greater cushion against economic downturns, reducing the need for premium rate changes. Given the size of the downturn experienced in 2009 and 2010, and PBO's projections of reserve deficits and premium rate changes that occur as a result, it may be the case that a reserve of $2 billion is insufficient to provide the desired level of premium rate stability. That said this determination would be conditional on the definition of stability and over which period of time EI expenditure and revenues are expected to break even. These definitions are not contained in the EI Act.

Further analysis of the type that has been performed by the CA in the past (for example see 1999 report on employment insurance premium rates) could be undertaken to better understand what would be required to improve rate stability over the business cycle and the implications for the annual reserve, given stable premium rates. In the past the CA analysis has included:

- Five-year (and longer) projections of program costs, premium revenues, EI Account balances, and premium rates under multiple unemployment rate scenarios (stable, downturn, and recession);
- Estimates of the average premium rate required to pay for benefits throughout the business cycle; and,
- The size of the reserve needed to ensure premium rates do not increase significantly during a recession[14].

[14] Chief Actuary's Report on Employment Insurance Premium Rates for 2000 contains detailed estimates and analysis on each of the these topics.

Annex A – Projection of Economic Variables and Insurable Earnings

Economic Projections

Projections of labour market variables incorporate data up to the end of 2009 while projections of National Income and Expenditure Accounts variables incorporate data up to the third quarter of 2009.

Projections of wages, salaries and supplementary labour income, net income of nonfarm unincorporated business (including rent) and nominal GDP are from PBO's Assessment of the Budget 2010 Economic and Fiscal Outlook (Table A-1).

In order to project EI benefit payments PBO begins by projecting the number of EI beneficiaries (BEN) using the following identity:

BEN = BU*LFU

where: BU is the beneficiaries-to-unemployed (B/U) ratio and LFU is the number of unemployed individuals.

The B/U ratio for 2009-10 is based on monthly data up to December 2009. For the first quarter of 2010 and 2010-11, PBO extends the declining monthly trend observed in the last three months of 2009, gradually reducing the B/U ratio to its pre-recession level based on the average observed from 1999Q1 to 2007Q4 (Figure A-1). This reduction is consistent with the removal of temporary benefit enhancements (5-week extension, benefit enhancements for long-tenured workers and work-sharing) from Budget 2009 and a gradual improvement in labour market conditions. Beyond 2010-11 the B/U ratio is held constant at its pre-recession level.

The number of unemployed individuals (LFU), is calculated using the following identity:

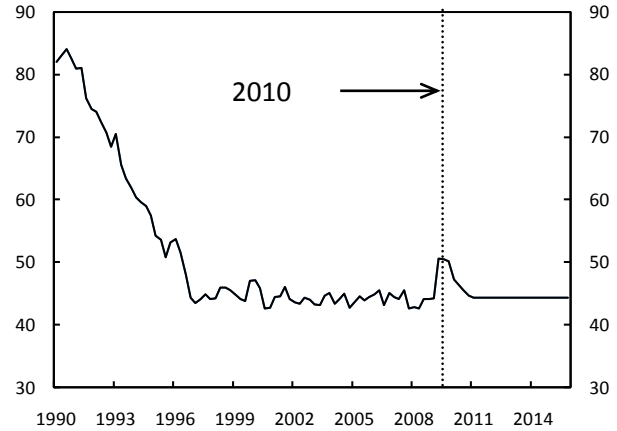
LFU = LFUR*LF

where: LFUR is the unemployment rate and LF is the size of the labour force.

Figure A-1

B/U Ratio

Per cent



Source: Office of the Parliamentary Budget Officer.

The projection of the unemployment rate used in PBO's Assessment of the Budget 2010 Economic and Fiscal Outlook was based on the Department of Finance's December 2009 private sector survey, while the size of the labour force was calculated by PBO using the following identity:

LF = LFPOP*LFPR

where: LFPOP is the working age population and LFPR is the aggregate participation rate.

The working age population was projected using the Statistic Canada's medium scenario population projection, while the aggregate participation rate is projected using an Okun's Law relationship which links the deviation of the participation rate from PBO's estimate of its trend to the output gap (the deviation of the level of real GDP from its potential).[15]

[15] For further details see http://www2.parl.gc.ca/Sites/PBO-DPB/documents/Potential_CABB_EN.pdf .

Table A-1

Projections of Economic Variables

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Economic Variables							
Total Employment	0.7	-1.3	0.4	1.4	1.2	1.3	1.0
Share of Self Employed in Total Employment (per cent)	15.5	15.9	15.7	15.8	15.9	16.0	16.0
Employees	0.7	-1.8	0.6	1.3	1.1	1.2	1.0
Average Weekly Earnings	3.2	2.2	3.8	3.0	3.4	3.2	3.5
Employment Insurance Variables							
Beneficiaries-to-Unemployment Ratio (per cent)	43.8	49.6	45.2	44.3	44.3	44.3	44.3
Unemployment Rate (per cent)	6.6	8.4	8.5	7.7	7.3	6.8	6.5
Regular EI Beneficiaries	529,828	769,808	705,356	636,592	604,648	568,307	550,551

Sources: Office of the Parliamentary Budget Officer; Statistics Canada.

Notes: All economic variables are displayed in period over period growth rates. The beneficiaries-to-unemployment ratio is based on regular benefits only.

Insurable Earnings

Historical insurable earnings data is from the T4 supplementary report contained in the Chief Actuary's (CA) reports. T4 information is collected by the Canada Revenue Agency and is only finalized once all tax receipts have been gathered, creating a time lag of two years (i.e. complete 2008 data will only be available in 2010.) PBO utilizes the CA data for insurable earnings up to 2009.

PBO utilizes the quarterly dynamic of wages salaries and supplementary labour income to convert the annual insurable earnings data into quarterly values[16].

The insured population excludes self-employed individuals because they do not pay EI premiums and are unable to collect benefits.[17] The ratio of unincorporated business income to nominal GDP is used to estimate the share of self-employed in total employment. Average weekly earnings (AWE) are defined as wages, salaries and supplementary income divided by the number of employees (total employment excluding self employed).

Average insurable earnings for the group at MIE are, by definition, maximum insurable earnings. This value is known for the first year of the projection because it is set in advance by the EI Commission.[18] In all years after the first year, MIE is calculated in exactly the same manner as in the CA reports except that PBO's forecast for average weekly earnings is used instead of wages from the SEPH. The number of individuals earning the maximum is equal to the share of total insurable earnings earned by individuals earning the maximum divided by MIE. The share of insurable earnings from employees earning the maximum is taken from estimates contained in the 2010 CA report and are held constant over the projection period.

The average earnings for individuals earning less than the maximum is calculated by taking total insurable earnings minus the total earnings of individuals at MIE divided by the number of individuals who earn less than the maximum (total insured population minus the number of individuals earning the maximum). For the

[16] These values are then scaled so that the average of the quarterly figures equals the annual CA data.

[17] Although the Government is proposing that EI benefits be extended to self-employed individuals, PBO has not modeled this expected change.

[18] Maximum insurable earnings for a given year are equal to maximum insurable earnings in the previous year multiplied by the growth in wages (year-over-year basis as of June 30th) from the Survey of Employment Payroll and Hours (SEPH) rounded to the nearest $100.

projection years, average earnings grow with average weekly earnings.

Total insurable earnings are the sum of the earnings from each group of employees (Equation 1).

$$IE = MIE_{num} \cdot MIE + XMIE_{num} \cdot XMIE \qquad (1)$$

Equation 2 is used to calculate the number of people who earn the maximum amount, where γ is the share of insurable earnings from employees who earn the maximum, MIE is maximum insurable earnings, XMIE is the average earnings of employees who earn less than the MIE and LEMP is the size of the insurable population.

$$MIE_{num} = \frac{\gamma \cdot XMIE \cdot LEMP}{(1-\gamma)MIE + \gamma(XMIE)} \qquad (2)$$

Similarly, Equation 3 is used to calculate the number of employees who earned less that the maximum.

$$XMIE_{num} = \frac{(1-\gamma) \cdot MIE \cdot LEMP}{(1-\gamma)MIE + \gamma(XMIE)} \qquad (3)$$

Table A-2

Insurable Earnings Projections

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Decomposition of Insurable Earnings							
Maximum Insurable Earnings (MIE, $)	41,400	42,525	43,500	44,650	45,675	46,775	47,925
Number of individuals at MIE (thousands)	6,453	6,404	6,587	6,686	6,797	6,906	7,012
Total insurable earnings of individuals at MIE	267,115	272,347	286,535	298,548	310,433	323,046	336,029
Average salary of employees under the MIE ($)	23,289	23,811	24,715	25,449	26,312	27,156	28,117
Number of individuals under the MIE (thousands)	7,974	7,757	7,662	7,753	7,797	7,862	7,898
Total Insurable Earnings of individuals under MIE	185,703	184,707	189,358	197,296	205,151	213,486	222,066
Share of insurable earnings at MIE (Per cent)	59.0	59.6	60.2	60.2	60.2	60.2	60.2
Insurable Population (thousands)	14,427	14,161	14,249	14,439	14,594	14,768	14,909
Insurable Earnings	**452,818**	**457,053**	**475,893**	**495,844**	**515,584**	**536,532**	**558,095**
Share of provinces with a Provincial Plan (per cent)	77.9	77.9	77.9	77.9	77.9	77.9	77.9
Insurable Earnings without a Provincial Plan	352,745	356,045	370,721	386,262	401,640	417,958	434,756
Insurable Earnings with a Provincial Plan	100,073	101,009	105,172	109,582	113,944	118,574	123,339

Sources: Office of the Parliamentary Budget Officer; Statistics Canada, Public Accounts of Canada

Notes: Insurable earnings are in millions of dollars.

Annex B – Projecting EI Premium Revenues and CEIFB Reserve Balances

PBO projects premium rates, on a calendar year basis, by utilizing a methodology consistent with the annual reports of the EI Chief Actuary and by interpreting the legislation that governs the EI rate setting mechanism (the EI Act and the CEIFB Act)[19].

The primary objective of the CA reports is to calculate the premium rate for which EI contributions will just equal the total costs of the program in a given year. PBO uses the same methodology to produce estimates of the total cost of the EI program[20]. However, under the new rate setting mechanism the premium rate is one that not only covers annual costs but also takes into account the value of the CEIFB reserve[21]. Therefore, PBO calculates a break-even rate that is the rate that would generate enough revenue to achieve a cumulative balance in the reserve of $2 billion[22].

Premium rates for 2009 and 2010 are frozen at $1.73 per $100 of insurable earnings for 2009 and 2010 so the new rate setting mechanism does not apply to those years. Guidance for projecting premium rates for 2011 and beyond can be found in subsections 66(1) and 66(7) of the EI Act. Subsection 66(1) states that the CEIFB shall set the premium rate in each year, subject to subsection 66(7), in order to generate just enough premium revenue in that year to cover expected payments and the repayment of any advances made to the CEIFB to cover past deficits in the reserve and to ensure that the fair market value of the reserve is maintained at $2 billion[23]. Subsection 66(7) restricts movements in the premium rate to $0.15 per year. Simply put, the CEIFB is required to adjust premium rates to compensate for any reserve balances that diverge from $2 billion as long as those rate adjustments do not exceed $0.15 per year[24].

Further clarification provided to PBO by HRSDC, indicates that the reserve comes into effect on January 1st, 2009 and that the CEIFB will be responsible for any deficits that occur in the reserve from that point forward. In addition, although the amended EI Act states that an amount of $2 billion may be paid out of the consolidated revenue fund to the CEIFB, no provision for this amount was outlined in Budget 2010. For its reserve balance projections PBO has assumed that the reserve is zero in 2008 and that the transfer of $2 billion to CEIFB will occur in 2011. Furthermore, PBO has assumed that advances made by the government to the CEIFB to cover deficits in the reserve will accumulate interest due to the government and that any surpluses in the reserve will earn interest that accrues in the EI reserve. The rate of interest is assumed to be the rate earned on 10-year Government benchmark bonds.

[19] PBO received assistance with the interpretation of this legislation during a January 28th meeting with Human Resources and Skills Development Canada.

[20] In addition to the benefit payments discussed in the main body of this note, total costs include administration costs, and the costs of bad debts, penalties, pilot programs, and wage-loss replacement plans.

[21] Following the CA methodology, premium rates are calculated separately for provinces with provincial plans (Quebec) and provinces without provincial plans. The difference between these two rates is projected to be a constant $0.34 per $100 of insurable earnings throughout the projection.

[22] The cumulative reserve includes all advances owed the government as a result of past deficits.

[23] Subsection 66(4) actually states that this reserve will be indexed, on a compound basis, beginning in 2009 but because the method of indexation is not contained in the act, PBO has not indexed the reserve.

[24] Subsection 66(8) allows for a premium rate change greater than $0.15 on the joint recommendation of the Ministers of Finance and HRSDC, if it is in the public interest.

Annex C – Review of EI Finances and Rate Setting Mechanisms

Financing EI

All EI benefits, and support measure in addition to administration charges are financed through payroll contributions of employees and their employers (employers pay 1.4 times the employee amount)[25]. Earnings are insured up to a maximum amount ($42,300 in 2009) and premium rates are established every fall for the following year by the EI Commission[26].

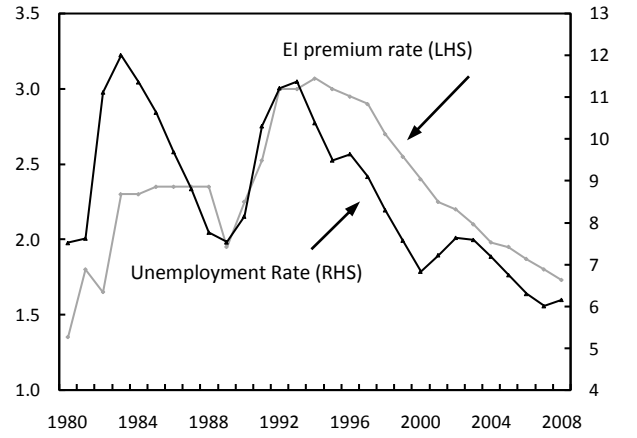
EI revenues and expenses including administration charges are recorded in the Employment Insurance Account – a consolidated account within Public Accounts of Canada. The financial statements of the EI Account are prepared by the management of the EI Commission and are audited by the Auditor General of Canada. Interest is earned on the balance of the Account pursuant to section 76 of the EI Act. All amounts received under the Act plus interest earned on existing balances are deposited in the Consolidated Revenue Fund (CRF) and credited to the account. Similarly, benefits and administration costs of the EI program are paid out of the CRF and charged to the EI Account.

Historical Premium Rates and Account Balances

Over the 1980 to 2008 period, premium rates generally moved in line with the unemployment rate (Figure C-1). In other words, when the economy was expanding, and unemployment was falling, premium rates fell and when the economy was contracting, and unemployment was rising, premium rates increased[27].

Figure C-1

EI Premium Rates and the Unemployment Rate



Sources: Office of the Parliamentary Budget Officer; Statistics Canada, Public Accounts of Canada

Notes: Premium rates are the rates paid by employees. After 2006, premium rates are for provinces without a provincial benefit plan.

This pro-cyclical behavior was a direct result of rate-setting mechanisms that set premium rates such that revenues would cover expenses (or an average of past expenses) with the ultimate objective of keeping the EI Account in balance. The fact that the premium rate moved in line with the unemployment rate, however, somewhat diminished EI's role as an automatic stabilizer.

EI program reform in 1993 and the expenditure review process announced in the 1994 and 1995 budgets significantly lowered the costs of EI[28]. However, premium rates increased in 1994 to $3.07 for every $100 of insurable earnings, before declining slowly to $2.90 in 1997. These two factors led to EI Account surpluses that began in 1994-95 (roughly $2.7 billion) and continued until 2008-09. On a cumulative basis (i.e. the sum of all past surpluses and deficits), the EI Account was in deficit until 1995-96 at which point large annual surpluses together with interest earned on past

[25] Prior to 1990 the federal government paid for all administrative expenses and provided a grant to the UI account equal to one fifth of the total contributions by employers and employees.

[26] This function will eventually be carried out by the CEIFB.

[27] An exception to this trend was the period from 1983 to 1988 where premium rates were essentially frozen amid concerns of the Government that increasing premium rates would impose an additional burden on the private sector that would hinder job creation and economic recovery.

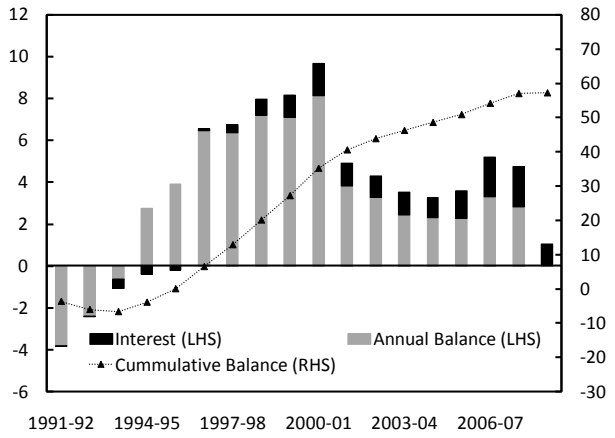
[28] The Chief Actuary Reports contain a detailed review of legislative changes to the EI program.

balances began to contribute to persistent cumulative surpluses totaling nearly $57 billion by 2008-09 (Figure C-2).

Figure C-2

EI Account Balances

(Billions)



Sources: Office of the Parliamentary Budget Officer; Public Accounts of Canada

Evolution of the Rate-Setting Mechanism[29]

Prior to the reforms of 1996, EI premium rates were set such that contributions covered a three-year average cost of benefits plus any amount needed to offset past deficits.

The 1996 reforms were implemented, in part, to reduce the pro-cyclical nature of premium rates by creating a buffer against future account deficits. Budget 1995 expected cumulative surpluses in the Unemployment Insurance Account of $5 billion by the end of 1996 and that "this surplus would be maintained and used as a buffer to mitigate unemployment insurance premium rate increases during periods of slowing economic growth."[30]

Consequently, the idea that EI Account surpluses would cushion against troughs in the business cycle was explicitly written into the Employment Insurance Act in 1996. In its original form[31] Section 66 of the EI Act stated that the EI Commission will set the premium rate each year at a rate which ensures there will be enough revenue over a business cycle to pay the amounts charged to the EI Account in addition to maintaining relative stable rate levels.

Despite the wording in the 1996 EI Act, the size of this buffer was never explicitly stated in the Act. However, the 1998 Report to the EI Commission by the Chief Actuary of EI states that, "a reserve of $10 to $15 billion would seem enough to cover the higher costs expected during a recession."[32] The cumulative surplus of the Account in 1998 was $19.2 billion, and annual surpluses continued.

The Auditor General of Canada's statement in the 2004 Public Accounts of Canada highlighted her concerns with this trend. She stated that in her view "Parliament did not intend for the Account to accumulate a surplus beyond what could be reasonably spent for employment insurance purposes, given the existing benefit structure and providing for an economic downturn."[33] Furthermore she noted that the EI Account balance stood at level three times greater than that recommended by Chief Actuary in 2001.

In response, the Government held consultations with the public with the objective of changing the rate-setting framework and ultimately made amendments to Section 66 of the EI act in Budget 2005, changing the wording to state that the premium rate would be set such that revenues would just cover expenses for the upcoming year and that the rate setting process would be based on information provided by the Chief Actuary in its annual report to the EI commission. After these changes came into force in 2006 the Auditor General of Canada stated that this change in legislation meant that, "the accumulated surplus can no longer be considered when calculating the

[29] Kevin Kerr, "Employment Insurance Premiums: In Search of a Genuine Rate-Setting Process", February 6th, 2009.
[30] Department of Finance, *Budget Plan 1995*, page 56.
[31] This section of the EI Act was subsequently changed in 2006.
[32] Chief Actuary's Report on Employment Insurance Premium Rates for 1998.
[33] Public Account of Canada, Volume 1, 2004, page 4.14.

break-even premium rate[34]". While this action alleviated the concerns of the Auditor General it also eliminated the ability of EI Account surpluses to act as a buffer against downturns, increasing the likelihood that premium rates would move in line with the unemployment rate.

Further towards reforming the rate setting mechanism, Budget 2008 announced the creation of the Canada Employment Insurance Financing Board (CEIFB)[35] that will have three main responsibilities[36]:

1) **Managing a separate bank account.** Any annual EI surpluses going forward will be held and invested until they are needed for EI program costs.

2) **Implementing an improved EI premium rate setting mechanism.** Starting in 2009, the new rate-setting mechanism will take into account any surpluses of deficits that arise on a go-forward basis, to ensure that EI revenues and expenditures break even over time. In order to provide rate stability, the maximum annual change in the premium rate set by the CEIFB will be 15 cents.

3) **Maintaining a cash reserve.** The Government will provide $2 billion to establish a reserve in the CEIFB's bank account. In the event of a downturn where the projected break-even rate would result in a premium rate increase greater that the 15-cent limit, the difference would be funded from the reserve in that year, which would be replenished in subsequent years through the premium rates. In the event of an economic upturn, and surplus beyond the desired reserve level would be used to reduce EI premiums in future years.

With the creation of the CEIFB, the premium rate setting mechanism has come full circle to where it was when the 1996 reforms were implemented. However, under the current legislation the CEIFB sets the premium rate to balance the CEIFB's reserve over the business cycle not the EI Account, effectively severing the link between the surpluses accumulated in the past and balances required in the future.

[34] Public Accounts of Canada, Volume 1, 2005, page 4.15.
[35] The CEIFB Act was part of the 2008 Budget Implementation Act. The CEIFB was created as a crown corporation.
[36] Budget 2008, page 71.